COMMISSIONERS
JEFF HATCH-MILLER - Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

ARIZONA CORPORATION COMMISSION

BRIAN C. McNEIL
Executive Director

Direct Line: (602) 542-4143
Fax: (602) 542-0765
E-mail: kmayes@azcc.gov

January 11, 2006

Mr. Jack Davis
President and CEO
Arizona Public Service
400 East Van Buren
Phoenix, AZ 85004

Re: Potential cost-cutting measures at APS in light of multiple rate increase requests, Docket No. E-01345A-06-0009

Dear Mr. Davis:

Arizona Public Service's decision to seek a 14 percent emergency rate increase, in addition to its recent surcharge request, leads me to pose several questions about what the Company is doing to tighten its own belt at a time when it is asking ratepayers to bear additional burdens.

Specifically, I am interested in knowing whether APS has considered any internal cost cutting measures to help mitigate the financial difficulties the Company currently faces. These could include, but are not limited to, cutting back unnecessary in-state and out-of-state travel, a reexamination of executive salaries or bonuses, and a limitation on unnecessary utility advertising. Furthermore, I would like to know if Pinnacle West Capital Corporation has considered additional equity infusions into APS, similar to ones completed in 2005.

Executive bonuses

As you know, in 2004 APS paid to its top executives more than $3 million in bonuses, on top of the base salaries that these executives received.[1] APS executive bonuses are awarded by an independent Compensation Committee, which focuses on a number of factors, most notably the Company's earnings and the performance of its stock each year. However, the Committee is also permitted to judge executive compensation by factors other than earnings.[2] It appears that a number of factors have arisen since 2004 that may be taken into account when Pinnacle West is assessing the performance of its top officers in the awarding of bonuses and stock incentives,

---

[1] See Pinnacle West's 2004 Proxy Statement on file with the Securities and Exchange Commission, available at www.sec.gov/Archives/edgar/data/764622/000095012405002334/p70402def14a.htm. According to this filing, five APS executives received $3,012,357 in bonuses and $2,877,534 in base salaries in 2004. In addition to these awards, these five executives receive other long term compensation in the form of stock (LTIP payouts totaled $409,418,005 for 2004) and other perquisites such as a pension and life insurance benefits.
[2] See Proxy Statement, page 20.

including their apparent failure to keep APS' natural gas purchases under the $776.2 million cap on annual power supply costs implemented under Decision No 67744, and what appears to be decisions that led to the Company's increased reliance on natural gas.

While it is critical to compensate utility executives in a way that recognizes the importance of their positions and encourages the retention of top-performing executives, million-dollar bonuses may appear excessive to ratepayers at a time when they are being asked to shoulder repeated rate increases. Have top managers considered forgoing some or all of their bonuses for 2005 and 2006 to reflect the performance of Company management and to help defray some of the costs the Company is seeking as part of its rate filings? If not, please explain why.

Utility advertising and corporate travel

In my travels throughout Arizona, numerous APS customers have approached me about the appropriateness of utility advertising that they consider to be unnecessary and even wasteful in view of the fact that APS is a monopoly, does not need to compete in the marketplace and is requesting rate increases. I would like to know whether APS has considered limiting its advertising budget to safety and conservation messages and eliminating at least temporarily all unnecessary branding advertisements. This would include, but not be limited to, advertising at professional sporting events and television and radio ads that are designed solely to promote APS.[3] Similarly, I would like to know whether the Company has contemplated cutbacks in non-essential travel in 2006, including but not limited to any first-class travel by company executives. If not, please explain why.

Dividend cuts

Additionally, I am interested in whether Pinnacle West has considered reducing its yearly dividend to help cope with higher gas prices. As stated in a May 18, 2005 news release by Pinnacle West:

> "The Company increased its annual dividend by 10 cents per share of common stock for the 11th year in a row. For the ten-year period 1995-2004, its dividend grew at an average annual rate of 7.8 percent, ranking first among U.S. electric utilities. By comparison, the industry average for the same period was a negative 1.4 percent growth rate."[4]

While I am cognizant that regular dividends can help attract investment to Pinnacle West and APS, in the short-term escalating and volatile gas costs would seem to require Pinnacle West to re-evaluate its dividend to determine whether some of those funds would be better applied toward the near term costs faced by the Company. Has APS or

---

[3] As part of APS' original request for a 20 percent rate increase, the Company stated that it was excluding $3.28 million in "branding" advertising from its rate request. It is unclear whether this number represents the Company's entire branding related budget, but even this amount appears to be a significant expenditure at a time when the Company is facing high fuel costs.

[4] It is salient to note that at least part of the Company's executive compensation program is tied to dividend performance. See Proxy Statement, page 20. Long term incentives take into account "the delivery of returns to shareholders in the form of share price appreciation and dividends over time."

Pinnacle West considered a partial or one-time reduction in its corporate dividend? If not, please explain why.

Capital infusion from Pinnacle West to APS

Finally, in 2005, the Commission granted a request by APS to increase its equity by $450 million through investments by Pinnacle West and the sale of the Silverhawk power plant in Nevada. Approximately $250 million will come from the issuance of common stock from Pinnacle West and $200 million will come from the Silverhawk sale. The equity infusion was done in order to strengthen APS' capital structure with the goal of helping address infrastructure needs over the next five years. At a time when the Company is facing high natural gas costs, and a pension fund that has become under-funded by $389 million, has management considered additional equity infusions into APS?

I look forward to hearing from you on this matter because your responses will aid me in my consideration of this case.

Sincerely,

Kris Mayes

cc: Chairman Jeff Hatch-Miller
Commissioner William A. Mundell
Commissioner Marc Spitzer
Commissioner Mike Gleason
Ernest Johnson
Brian McNeil
Heather Murphy
Docket